# 1
## Current Central Government Finances

Today the finances of the People's Republic look strong. The country has relatively little debt. Surging foreign exchange inflows have resulted in the second highest pool of reserves in the world behind a sagging Japan. Tax collections are on the upswing. The consensus view, both in the United States and around the world, is that Beijing's leaders have gotten their house in order. They have, to borrow a phrase used by the nation's finance minister, Xiang Huaicheng, entered "a virtuous cycle."[1]

That is what most analysts think. The reality, however, is difficult to ascertain, and no one, at least no one outside a tight circle of technocrats and political leaders in Beijing, knows where China's finances really stand today. Maybe even they are not sure--everyone is the victim of bad statistics, as discussed in Appendix 1.

It is important to outline what most of the world does not know to put this discussion into context. There are two items of special importance. First, there is the financial relationship between the central government and the 31 provinces (in reality, the 22 provinces, five "autonomous regions," and the four provincial-level cities of Beijing, Chongqing, Shanghai, and Tianjin). In March Finance Minister Xiang helpfully provided a breakdown for 2001: the central government ran a deficit of US$31.4 billion and lower level governments enjoyed a surplus of US$1.5 billion.

The underlying problem is the murky financial relationship between the central and provincial governments. The World Bank is now trying to better understand this complex relationship, but it is unlikely that any outside observer will be able to provide an accurate picture. There are interrelated obstacles for those wishing to have a better understanding of the situation: the interaction between the center and the fringes is not only opaque but changing.

Although official sources separate central versus local numbers, information is difficult to understand. For one thing, local governments sometimes forward revenues to the central government and central authorities pay subsidies or send tax revenues to local governments, especially those that are in "difficult" circumstances.[2] These transfers are often not reflected in government statistics.[3] Therefore, published numbers are inaccurate. And, at least as a practical matter, there is no way to reconfigure these statistics.
The system is complicated, or perhaps simplified, by impending changes in the method of

sharing revenue. Xiang Huaicheng devoted part of his budget message at the last annual meeting of the National People's Congress to the changing allocation of income and personal tax revenue between the center and the provinces.[4]

Despite all the complexity of this topic, there is an overriding reality: the central government cannot allow local governments to fail. When Orange County in California went bust in the 1990s, the operations of the Federal government were unaffected, but in China the lines separating the various levels of government are not so clearly drawn, due in part to the unifying force of the Communist Party, which dominates Chinese society. So, whatever formula that is derived for allocating revenues in the future, Beijing will come to the rescue of local officials whenever needed. Indeed, Xiang's budget report details Beijing's assistance to local governments in 2001[5] and proposals for 2002.[6] There are many levels of governance in China, but there is only one government.

The second item of special importance is the undisclosed spending of the central government. Figures are released to the public, but few think that they reflect reality. This year, like years past, many questions have gone unanswered by official budget presentations. As an initial matter, released statistics do not include many items.

For example, the announced budget for the People's Liberation Army is undoubtedly less than the real one. The PLA is, of course, funded by the state, but it reports to the Communist Party. So, in addition to being the world's largest military, it is essentially the world's biggest private army. Its budget, not surprisingly, is private too. Analysts indicate that the reported budget is only a half, third, quarter, or a fifth of its actual size. Only a few people in Beijing know for sure.

Much is hidden from the people in the budget of the People's Army. They are not allowed to see procurement costs of large items, such as the Russian destroyers and jet fighters. Those are handled separately through hidden channels. Also not included are the costs for the People's Armed Police, which appears indistinguishable from the PLA. Research and development costs are scattered throughout China's version of the military-industrial complex. In general, amounts are hidden in budgets for civilian agencies, and, almost without question, some expenditures are not included in the totals revealed to the public. And of course the PLA does not show us what should not be there: the income from the businesses that it should have divested.

Except for a few estimates that are dismissed as widely exaggerated, the most that anyone thinks that China annually spends on defense is around US$95 billion, about five times its announced military expenditures.[7] A more realistic estimation is three times the announced budget. For this year the official budget is US$20.0 billion, an increase of 17.6 percent from last year.[8]

The American intelligence community, despite its unrivaled resources, was not able to derive a good estimate of Soviet defense spending. Even though Beijing these days maintains a more open society than the Soviets once did, it is not surprising that we still are at a loss when it comes to Chinese budgetary items.

It is also believed that spending in other areas is not included in official figures. We have, for instance, little idea of what the state devotes to its program to put a Chinese socialist into orbit, onto the surface of the moon, and inside the country's planned space station.[9] Space, the high ground, is a high priority for the Chinese state. Its effort is closely allied to the PLA, so its budget is a closely guarded secret.

What are not secrets are the trends in China's finances--they are visible even to the naked eye of casual observers. Yes, there is more that we would like to know about Beijing's budgetary matters, but the hidden items are not as important as what we can see. Today, not only alarmists are becoming alarmed by China's budgetary trends.

The most important trend is this: the People's Republic is moving towards a debt crisis. Today, the situation appears manageable. In 2001 China (the central government and the provinces combined) suffered a budget deficit of US$29.9 billion, at least according to Finance Minister Xiang's work report delivered to the National People's Congress on March 6 of this year.[10] He announced revenues of US$197.7 billion and expenditures of US$227.6 billion. That, on the surface does not appear so bad, especially because the deficit in 2000 was even higher: US$30.1 billion.

The 2000 deficit was a record for the People's Republic, but that honor will not last long. Last year Xiang Huaicheng predicted that the 2002 budget deficit would be "bloated."[11] He was a man of his word. His projected deficit for 2002 is a record. Total revenue will be US$217.6 billion, up 10.1 percent. Expenditures, on the other hand, will increase 12.0 percent to US$255.0 billion.[12] The projected deficit for this year (US$37.4 billion) is about 25.1 percent higher than 2001's actual shortfall.

The whopping increase in the deficit is the "price to pay" for "healthy and sustainable growth," says Minister Xiang.[13] Although it is true that the state has been shelling out large sums, massive stimulus has not produced growth that is sustainable. Every year since Zhu Rongji became premier in 1998, the state has tried to jump start the economy with government spending on a large scale.

Some observers have been saying that China's spending spree must end soon,[14] something even bureaucrats have implicitly acknowledged.[15] Central government officials, especially those from the Ministry of Finance, have from time-to-time discussed winding-up the fiscal stimulus program, mentioning the temporary nature of increased state spending. Two years ago they even talked about ending the program this year.[16] Officials, however, no longer utter those words. Although state spending is inefficient, central leaders apparently see no alternative to direct intervention in the economy. Premier Zhu, speaking in March of this year at what is probably his last press conference, said that the Chinese economy would have "collapsed" without his "proactive fiscal policy and a prudent monetary policy."[17]
Now that the central government is keeping the economy going, it has another problem: deficit spending. Spending on this scale is not sustainable. Central leaders, having failed to ignite either consumer spending or the non-state sector,

do not know what to do next. Among those alarmed are deputies to the National People's Congress. This March witnessed unprecedented criticisms of the central government's stimulus program, perhaps the only interesting story from this meeting. "When he took over from premier Li Peng, the Government's accumulated debt was 46 billion yuan," said a Mainland economist. "Now it has mushroomed to 500 billion. So some NPC members say, half jokingly, that Zhu cannot retire next year because he must continue the burden of paying back that money."[18]

Zhu accepts no criticism of his management of the country's economy. Responding to a question that had obviously been arranged at his press conference,[19] the economic tsar devoted about 15 minutes to explaining why he should not be known as the "deficit premier," a title he received from the respected *Hong Kong Economic Journal* a few days before. After noting that he had a policy of not accepting honorary titles, the premier, protesting much too much, launched into a broad defense of his stewardship.

The premier did not invent deficit spending in the People's Republic. After all, the country last had a budget surplus in 1985.[20] He did, however, perfect the technique: deficits have zoomed up under his tenure, increasing every year of his spending spree except for 2001, as illustrated in Figure 1.1.

**Figure 1.1**
**Announced Government Deficits**
**1998-2002**
**(US$bn)**

| 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| 11.1 | 21.1 | 30.1 | 29.9 | **37.4(est)** |

source: China Statistical Yearbook 2001
People's Daily Online

The feisty premier says that deficits have not been used to make up budget shortfalls. For example, this year he told Morgan Stanley's chief economist, "Every single penny is going to infrastructure spending."[21] Every single penny? First of all, some of those coins have rolled out of the country into personal bank accounts. Late last month Lu Wanli apparently stole so much money that he was able to flee China with his extended family. The former transport chief of poor Guizhou Province has been accused of taking funds that were raised through Zhu's treasury bonds.[22] Nobody, except the premier, thinks that Lu was the only one to misappropriate cash from the country's infrastructure kitty. Second, increased salaries for government workers, an important part of the stimulus program, have been financed by spending in the red. There were two such salary increases in 2001.[23]

Zhu, trying to craft his legacy, is on firmer ground when he says that stimulus builds infrastructure that will benefit society, and the economy, in the long run. He says that he has created about US$300 billion of "superior assets that would bring about tremendous economic benefits" in the future. [24] China, unlike Japan, can use all of the highways, dams, and railroads that it is so furiously building. Yet he does not say what even a casual observer can tell you: China will not need much of this infrastructure for years, perhaps even a decade or two. More important, the premier has authorized other spending undertaken by state-owned enterprises but financed by state-owned banks. The increased exposure will have undesirable consequences for these financial institutions, which are already in serious, if not worse, condition as discussed in Appendix 2. The economy is receiving a short-term boost by his US$60 billion of stimulus, but the cost is long-term pain.

In the short-term, China can afford to spend to get itself out of a tight spot. That conclusion is evident when we look at the traditional yardsticks of the ratios of annual deficit to gross domestic product and total debt to GDP. Zhu Rongji invites us to do so, because that was such an important part of his strident defense. He stated that the central government's budget deficit was only 3 percent of GDP and total public debt was 18 percent of GDP.

As an initial matter, Zhu's co-conspirator in bad statistics, Finance Minister Xiang Huaicheng, had more authoritative numbers: 2.7 percent instead of 3 and 16.3 percent instead of 18.[25] To put these ratios into perspective, 3 percent is the internationally recognized safety limit for annual deficits and 60 percent is the corresponding figure for public debt.

Neither set of numbers, Zhu's or Xiang's, indicate danger. There are two initial points to remember, however. First, the central government calculates its public debt ratio without including US$32.5 billion of sovereign debt incurred in 1998 to partially recapitalize the four largest state-owned commercial banks and, more disturbingly, US$169.1 billion in implicit Ministry of Finance obligations derived from the most recent clean-up of these commercial institutions (US$157.0 billion) and the three "policy" banks (US$12.1 billion).[26] The central government admits to US$188.5 billion in debt,[27] but no one believes that comes anywhere close to the real number.

Second, China's GDP numbers are undoubtedly inflated. This statistical distortion, discussed in Appendix 1, makes these ratios appear far better than they really are: the lower the GDP, the higher these ratios become. Because no one knows the true size of the Chinese economy today, no one precisely knows what these ratios are. It is nonetheless apparent from what is known that, if accurate numbers were available, the annual budget deficit ratio would be pushed over the 3 percent mark and the public debt ratio would still be inside the 60 percent mark.

Apart from these statistical distortions, it is not entirely clear that the use of the two ratios is appropriate when discussing the People's Republic. Essentially, the problem is one of definition. China, even to this day, maintains a system whereby the state owns and operates the major actors in the economy. The banks and state-owned enterprises are not sovereign in and of themselves, but the system works because the state stands behind them as a practical matter: the central government not only owns them but backs them. In a country with a free market it makes sense to calculate these ratios with only sovereign obligations. In China's centrally-directed economy, however, all the state's commercial instrumentalities need to be considered. Moreover, in a modern state one can draw distinctions among various layers of government and talk of their respective financial obligations. As noted above, those distinctions make less sense in a unitary state like China.

Accordingly, both the annual deficit and public debt ratios would be substantially inflated if China's "hidden obligations" are added. The central government tells us not to worry. For example, Dai Xianglong, the head of the central bank, reminds us that "the deficit is still far from the internationally accepted limit even when taking into account other hidden debts, including the mammoth non-performing assets accumulated in past decades by State-owned commercial banks, debts from local governments, and depleted social welfare accounts."[28] And Finance Minister Xiang seeks to comfort us when he says, "The Party Central Committee and the State Council are paying close attention to some long-standing, hidden financial risks and taking measures to eliminate them step by step."[29]

Should we feel reassured? As an initial matter, it is an important step in the right direction for the state to acknowledge that it must discuss the hidden obligations. Yet its disclosures still mask a reluctance to talk about the issues in a responsible fashion. Beijing still does not reveal important information and continues to mislead with the scanty data it does provide. Foreign analysts still have to manually tabulate or reverse engineer important statistics. In short, we still have only a fuzzy picture of the true state of the country's financial condition. At best, Zhu's and Xiang's ratios portray the finances of the central government at their prettiest and are only a starting point in discussing the country's financial condition.

To figure out the true obligations of the central government, one must know how to add. These squishy numbers can be combined in many different ways, however, depending on assumptions made and numbers used. Finance Minister Xiang can say that the debt ratio stands at 16.3 percent, but others believe it is over 100 percent. Merrill Lynch came up with 120 percent for the year 2000, when China's obligations were lower than today.[30] Goldman, Sachs economist Fred Hu says the ratio may be as high as 150 percent.[31] You can even get the ratio to approach 200 percent and still stand on firm ground (sovereign debt of US$270.1 billion plus US$169.1 billion of implicit Ministry of Finance obligations plus unfunded pension and other social security obligations of about US$850 billion plus indirect loans of around US$855.7 billion).

One can, with good justification, use different variables based upon arguments over the central government's responsibility for various expenditures. For instance, in place of indirect loans to the state, one can use in the public debt ratio the estimated amount of nonrecoverable loans in the banks (about US$510.0 billion): this is the amount that the state needs to recapitalize them so that they can discharge their obligations to their creditors (such as depositors). The variables, although not endless, are staggering in their variety and complexity.

The computation of the ratio is even more complex: experts usually do not include other items that deserve to be counted, the hidden "hidden obligations" so to speak. Dai Xianglong deserves an award for candor by including local government problems in this list, thereby highlighting a problem that has generally escaped attention outside China. Many lower level government officials have not been paid in months and some for longer than that according to Han Dongfang, the Chinese labor activist now exiled to Hong Kong.[32] Beijing mandates that the lowest levels of government carry out programs (such as those to implement the one-child policy and to suppress unregistered religions) but does not provide financial resources to enable them to do so. Moreover, local governments, especially in rural areas, are infested with corruption and burdened by overstaffing, especially overstaffing resulting from the hiring of relatives of officials.

The central government has taken it upon itself to help fund these overdue payments, which in 2001 were estimated to total about US$785 million (or 1.8 percent of total wages). Last year Beijing transferred US$11.4 billion to local governments for salary payments.[33] In the 2002 budget Finance Minister Xiang is allocating US$14.3 billion to help local governments pay wages.[34] The central government's plan to spend US$2.9 billion more in 2002 than in the previous year (when back wages were supposedly under a billion) appears, at first blush, to be an unprecedented act of generosity.

In all probability, it is not. The revenue situation in the countryside is probably more serious than the central government is willing to reveal. In 2001 Beijing spent much more than it had originally budgeted for local government salaries.[35] In short, local government finances are tottering, and we have little idea how bad the situation really is.

Finally, the central government has chosen to ignore the failure of local governments to provide education, health care, and other essential social services to tens of millions of its own citizens. Beijing's leaders talk about helping the poor, the elderly, and the peasants, but the problems persist from year to year. The cost of these unprovided services may not be a "hidden obligation" as we understand that term, but there is a hidden cost of failing to tackle these issues, a cost that must one day be paid.

So what is the real public debt ratio? The Merrill Lynch estimate of 120 percent certainly is too low because it underestimates unfunded pensions and indirect loans. Merely adding the maximum amount of all these obligations also distorts the picture because this ignores the impressive capacity of the central government to defer its problems. A few percentage points beyond the upper limit of Fred Hu's range (150 percent) is probably the best estimate.

Yet however one computes these ratios, the bottom line is that the finances of the People's Republic are much weaker than first appears. They are shaky, if not precarious. Fortunately for Beijing, it has time to figure out how it will meet its burdensome financial obligations because there are a few bright spots in this picture: China is collecting more revenue, the country has enormous foreign exchange reserves, and it has the capacity to borrow more both domestically and abroad.

First, tax collections have jumped due to a concerted effort to combat fraud in both general taxes and customs duties. Revenue increased by a healthy 13.4 percent in 1999 and an astounding 22.8 percent in 2000 according to Beijing's statistics. The official increase for last year was 22.2 percent, and that translated into about US$19.5 billion of increased revenues.[36] Although tax officials have manipulated statistics, the country has nonetheless made great strides in this area. China is, however, still behind most other nations when measured by collections as a percentage of GDP. In this case, upward fabrication of GDP diminishes the appearance of China's ability to collect tax, so China is in better shape than the traditional GDP ratio suggests.

The trend is fantastic, but the issue is how long it can continue. The good news is that there is much room for improvement: perhaps no country has a more chaotic and disorganized system for the collection of revenue than the People's Republic.[37] China's tax collection system has been described as "eating in separate kitchens."[38] Maybe a better phrase is the "eat what you kill" system. Various levels of government collect what they can, and then negotiate as to who keeps what in unstructured negotiations. Today, tax collectors from different levels of government struggle with each other as if they were competitors, which, in effect, they are.

The current division of responsibilities among state and local authorities results in, not surprisingly, the protection of local firms by local tax authorities.[39] Municipalities, especially those far away from Beijing, brazenly defy the center. Local government units, such as local courts, have kept fees they collect and have, at least up to now, kept them off the books. As described above, Beijing is trying to impose some order on this situation. Nonetheless, structural improvements may not be made for years as senior cadres have yet to decide what a permanent system should look like. When they do, they will have to tackle the really hard part: implementation.

Just how far the system has to go to improve was illustrated recently, to some embarrassment to tax officials in the Chinese capital. In March of this year it was revealed that four, and only four, of the 50 richest entrepreneurs as listed by *Forbes* made it onto the list of top 50 taxpayers.[40]

Although 46 more rich Chinese can afford to pay additional tax, there are limits to how much revenue can be raised. For one thing, tax rates are about as high as they can go for domestic taxpayers. The only group that will see a rise in rates are foreign businesses, which have benefitted from preferential taxation throughout the reform era, the period beginning in December 1978 with Deng Xiaoping's assumption of power and continuing through today. With China's accession to the World Trade Organization, they will eventually be put on the same basis as their domestic competitors. What WTO giveth to foreign companies, it also taketh away.

If there is going to be a big jump in revenue, it will have to come from enhanced enforcement. The prognosis for a big jump in collections, in the tradition of the last three years, is not good, however. Last year's impressive tax take looks like a one-off performance. Tax revenue in future periods will be partly allocated between central and provincial authorities on the basis of tax collection patterns in 2001; thereby provincial revenue authorities had a big incentive to show good results by the end of last year.[41]

Most important, the Chinese are already heavily taxed both in the countryside and the city. Although official statistics show that the People's Republic raises revenue equal to 17.1 percent of GDP, a figure that is low by international standards, the people suffer from taxation with Chinese characteristics--onerous taxes disguised as fees and charges, many of them illegal. Professor Richard N. Cooper, testifying before the Commission last December, noted that the country's "extra-budgetary revenues" bring China up to where it should be in revenue collected as a percentage of output. Revenue of this sort amounts to about a third of budgeted expenditures, an incredible percentage.

Professor Cooper is certainly onto something. We know that published statistics do not include substantial local government revenues that are illegally assessed. Across China Communist party cadres in villages and townships collect unauthorized fees from peasants. Onerous and arbitrary taxation is a source of continuing instability in the countryside and is perhaps the primary cause of unrest in Chinese society today. In some areas peasants pay about a half of their income in taxes when they should pay only a small percentage of that. In the largest such outburst in recent years, about 20,000 peasants tore down the homes of corrupt officials in southern Jiangxi Province in August 2000 in a tax revolt that quickly spread from village to village and county to county.[42] These days there are frequent reports of peasants committing suicide because they cannot pay their taxes.[43]

The central government, concerned about the implications for social stability, is attempting to change the basis of rural taxation. The essence of Beijing's plan is to replace the dozens, even hundreds, of fees and charges with one centrally-administered tax. It had tried the "tax for fee" experiment on a wide basis but scaled back its initial effort.[44] That temporary retreat led to an attempt to implement the concept in eastern Anhui Province two years ago, an experiment that was extended to Jiangsu Province and about 100 counties in other provinces last year. Beijing is now talking about expanding the experiment to still other areas.[45]

The planned expansion of the experiment is more a reflection of its failure than its success. The central government essentially put the Anhui plan[46] on hold last July [47] after complaints from officials that local governments were losing revenue and therefore faced bankruptcy.[48] The central government could have made the program a success if it would have made up the shortfalls, but the loss of revenue was then considered too substantial.[49] Central leaders know the critical importance of changing the method of taxation in the countryside yet apparently can do little to implement their plans. Success of the wider experiment is unlikely given the failure of the smaller program.

Now, the State Council says that it will compensate local governments and provide "extra care" to minority areas, poor regions, and major grain producing areas. Analysts say the subsidies could be, in the words of the *South China Morning Post*, "several hundred billions of yuan."[50] Education is likely to be the first casualty as officials pay themselves first. The State Council has asked local governments to reduce payrolls, but that is more a hope than an expectation.

The Anhui experiment highlights an important point. Technocrats know what do to reform the nation's chaotic tax system but appear unable to implement their plans. The central government's track record in replacing local fees with central taxes is nothing short of dismal. Just this month Beijing announced that it will not put into place the oft-delayed fuel tax.[51] So the prospects for reform of rural revenue collection is clouded, to see the least.[52]

The battle over taxes and fees will continue, but it is unlikely that we will see a substantial improvement in revenue collection throughout the duration of the current five-year plan. The gains of the past three years were made from a very low base. The low-hanging fruit has already been picked, and now the hard work begins. Moreover, there are a few trends that do not help. Accession to the World Trade Organization will result in the reduction of import taxes and lower tariff rates, so revenues will go down at first.[53] More important, Mainland economists know that the revenue drive cannot continue for long because it is choking the economy.[54] These days tax collections are increasing about three times faster than the growth in GDP.[55] Not surprisingly, the economists are beginning to recommend a general reduction in taxation. There will be a small cut in tax rates this year,[56] but the country needs a much bigger rollback to get the economy moving again. When Beijing finally slices rates, collections will dive in the first year or so.

Figure 1.2 shows estimated revenue collections for the central and provincial governments. Estimated collections for this year are more than the US$217.6 billion that the Finance Ministry has budgeted[57] because the estimates include "extra-budgetary revenues" (which do not appear in that ministry's numbers) less the amount of such revenues that leak out of the system due to corruption.

**Figure 1.2**
**Estimated Government Revenues**
**2002-2005**
**(US$bn)**

| 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|
| 292.7 | 304.0 | 291.1 | 277.0 |

Figure 1.2 shows that revenues will decline as the economy slows. Already there are indications that collections will decrease: more listed companies reported losses in 2001 than in previous years.[58] As the economy continues to stagnate, this trend will continue.

The nation's gigantic foreign exchange reserves provide a cushion for the central government, of course. Both domestic and foreign commentators often say that this or that problem is not so bad because the nation has so much foreign currency stockpiled by Beijing. It is undoubtedly true that the country can weather problems because it has such a big stash, which has been accumulated from strong export growth and inward flows of foreign direct investment. China's foreign exchange reserves at the end of 2001 topped out at US$212.2 billion, up a staggering 28.1 percent from the year before.[59] At the end of the first quarter of this year they stood at an astounding US$227.6 billion.[60] Adjectives are insufficient to describe the increases.

The reserves should continue their upward climb for at least this year and next, but the rate of growth will slow. As noted below, the long streak of export surpluses will end soon and FDI will taper off as well. Nonetheless, China has the luxury of time provided by the reserves, at least for those problems that can be solved with money.

Does China really have all the foreign exchange it claims? Has corruption reduced the amount in government hands? No one outside a small circle in Beijing knows the answer. There was intense speculation when Li Fuxiang apparently committed suicide in May 2000 by jumping out of a seventh story hospital window. Li, then head of the State Administration of Foreign Exchange (SAFE), was under investigation for corruption according to most accounts. SAFE is, as it was then, responsible for the safekeeping of the nation's foreign exchange reserves.

Li's untimely death did not close the book on this story. In prison near Beijing is Zhu Xiaohua, one of Li's predecessors as head of SAFE. He disappeared from view in 1999. The lack of official comment just fuels the rumors about problems with the foreign currency reserves. An investigation by the *Financial Times* shows that the reserves "have sometimes been used for unorthodox purposes."[61] That paper has reported that officers at several lower-tier state banks (including Shanghai Pudong Development Bank, Guangdong Development Bank, and Everbright Bank) have confirmed that they received funds from the reserves in transactions not made public. Everbright, by the way, was once headed by Zhu Xiaohua.

In any event, the reserves, whatever they may be, give the government time to solve the hard problems. While it does so, it will have to borrow to keep the government going. Today, the state can easily issue its obligations at home and abroad. Global offerings are quickly snapped up, although each sale is dogged by rumors that the central government arranges to have its instrumentalities buy up its bonds through their offshore accounts.

The same thing happens at home, as the central government makes sure that domestic treasury offerings are sold out. Beijing, up to now, has been able to tap an enormous pool of domestic savings. The banks are swollen with the deposits they have taken in from the public, and they have to put those funds to work somewhere. As mentioned in Appendix 2, the Big Four banks buy the state's debt.

Individuals are also swept up by "bond mania," as *China Daily* terms it. This official newspaper explains why ordinary citizens wait in lines for hours to buy government obligations: "Bond fever spread like wildfire across the nation."[62] There is no doubt that bonds are popular among retail investors. In the words of Wang Mingshan, a National People's Congress deputy, "government bonds still have a good reputation" with Chinese "grassroots investors." Yet the leaders in Beijing know full well why they can sell their obligations so easily. Wang tell us that "investors still lack better investment alternatives for stable returns."[63] Maintain a closed system, and you can sell almost whatever you want.

It is significant that Beijing has done little to modernize its equity markets, which could threaten this cozy relationship between a government that needs cash and a populace that saves so much. Viable investment alternatives could spoil the government's funding schedule. Moreover, it is no accident that the government has not done much to develop the domestic bond market. As Thomas Byrne of Moody's Investors Service testified before the Commission last December, corporate bonds only account for about one percent of the market and their role is diminishing. The central government under no circumstances wants to promote competition for itself in the debt market.

This is not to say that there have been absolutely no improvements in the domestic debt market. By and large, reforms we do see are designed to help the government sell more of its own bonds. Technocrats will, when the mood strikes them, tinker with rules so that they can find new purchasers of its obligations. Late last year, for instance, the People's Bank of China, the central bank, allowed the Big Four commercial banks to conduct over-the-counter bond trading on an experimental basis. Now, investors will be able to trade bonds through the market operated by commercial banks pursuant to new rules.[64]

Beijing leaders, by forestalling reforms of the financial system, have been able to keep the game going. It is no exaggeration to say that the timetable for implementing their economic reforms, and maybe their political ones as well, is determined by how long they can borrow domestically and abroad. Therefore, the technocrats make every effort to defer expenditures to protect the nation's credit rating. Additionally, they carefully manage the nation's borrowings to make sure that little of China's debt, only about 20 percent, is short-term.[65]

Yet despite expert management, Zhu Rongji's spending spree is beginning to create stress. With stimulus costing about US$20 billion a year and budget deficits now almost double that figure, China is heading toward a showdown. A crisis probably will not occur during the current five-year plan, but it could, and undoubtedly will, arise soon thereafter.

The numbers give cause for concern, especially because central leaders cannot give us a good accounting of their debt. Foreign debt was US$170.1 billion at end of 2001 according to the official *People's Daily*.[66] That number does not compute, however, because Finance Minister Xiang told the National People's Congress this March that China's total indebtedness was US$188.5 billion at the end of last year.[67] Yet the country has issued US$61.7 billion in special treasury bonds over the past four years alone.[68] Someone has not been telling the truth.

The real amount of sovereign debt has been climbing rapidly. This report estimates that such debt was US$270.1 billion at the end of 2001, a 9.5 percent increase over the previous year. The amount of such debt at the end of 2000 (approximately US$246.6 billion) represents a 16.2 percent increase over the amount of debt at the end of 1999 (US$212.3 billion). The 1999 figure, in turn, is 25.7 percent larger than the debt at the end of 1998 (US$168.9 billion).[69] These figures are contained in Figure 1.3.

**Figure 1.3**
**Sovereign Debt**
**1998-2001**
**(US$bn)**

| 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|
| 168.9 | 212.3 | 246.6 | 270.1 |

source: undisclosed for 1998-2000
figure for 2001 is author's estimate

In every year the amount of issued debt has increased,[70] and so has the nation's sovereign indebtedness. Yet these are not the only problems. Net issuance of treasury debt as a percent of central government expenditures has been climbing rapidly, and it's now about half according to Brookings scholar Nicholas Lardy.[71] China has been running large budget deficits even though the economy is growing at a fast pace according to official statistics. Economic strategist Chi Lo from Hong Kong wonders what will happen when the economy slows.[72]

Premier Zhu is undeterred by the rising chorus of criticism. He has not indicated when stimulus and deficits will end.[73] The most definite statements come from Finance Minister Xiang. "The proactive fiscal policy will definitely be phased out eventually," he says.[74] "But this will be a gradual process and could take several years." [75] Because high growth, for good reason, has become fixed policy, it is most unlikely that we will hear a commitment to end the stimulus program before the end of the current five-year plan. "I cannot give you a timetable," Xiang says these days.[76]

We know it will not be anytime soon because the central government is set to tap the international markets for more money. Beijing hinted that it would issue sovereign debt on global markets in the near future. "It is opportune to go to the international capital market," Xiang Huaicheng said last month.[77]

He would be smart to do so right away: the erosion in the finances of the central government was evident in the numbers for the first quarter of this year. Expenditures rose 23.9 percent during this period while tax revenues increased just 3.4 percent from the same quarter last year.[78] No outside commentary on this turn of events is needed: Finance Minister Xiang himself had one word for the central government's spending during the first quarter of this year: "reckless."[79]

"No country, and no finance minister, can carry out a proactive fiscal policy over the long term and not have some problems emerge,"[80] remarked the current finance minister. That is understatement, especially when it is measured by Xiang's other comments. "The fiscal situation is grim," he said. "Revenue is growing too slowly and expenditure is growing too fast. Not enough money is being collected and too much is being spent."[81]

Until he can patch up the situation economists will continue to utter the words "China" and "Argentina" in the same sentence. There is "a potential time bomb," writes Chi Lo.[82] Like that South American country, the People's Republic can go from boom to bust in just a few short years. Both countries created growth through fiscal means, attracted foreign direct investment, and pegged their currencies to America's. Argentina was hit when there was a fall in the demand for its debt obligations. Both countries stuffed their banks with their bonds.[83]

Argentina deferred reforms by living on foreign capital, and China today plays this game too. The Latin American country did not have to undergo the shock therapy of accession to the World Trade Organization; China must do so now.

Chi Lo says that the Argentine experience is relevant to the People's Republic. Capital flows to a country are primarily the result of global liquidity. Because China now lives on inward flows, "its ability to sustain investor confidence is crucial." And the future? "As and when the flow of international capital tightens again, China's deteriorating fiscal and debt conditions will come under international scrutiny."

The People's Republic, Mr. Lo says, has a few more years to make things right by slowing the spending, collecting more taxes, and implementing reforms. But as the country's economy decelerates something else happens: time becomes precious.

---

1 "a virtuous cycle": Huo Yongzhe, "Boosting Demand a Key Goal," *China Daily*, March 7, 2001, p. 1.

2 "difficult" circumstances: National Bureau of Statistics of China, *China Statistical Yearbook 2001* (Beijing: China Statistics Press, 2001), p. 244 (hereinafter cited as *Statistical Yearbook 2001*).

3 not reflected in government statistics: *See Statistical Yearbook 2001*, p. 244.

4 Xiang Huaicheng devoted part of his budget message: *See* "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

5 Beijing's assistance to local governments in 2001: "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

6 and proposals for 2002: *See* “Full Text of Finance Minister’s Budget Report (II),” People’s Daily Online, March 17, 2002.

7 about five times its announced expenditures: Defense expenditures are published in China’s statistical yearbooks, and the most recent announcements are contained in finance ministers’ work reports delivered to annual meetings of the National People’s Congress.

8 US$20.0 billion: Josephine Ma, “Massive Defence Budget Rise in Line with Growing Economy, Says Chief,” scmp.com, March 6, 2002. For more information, see “Full Text of Finance Minister’s Budget Report (II),” People’s Daily Online, March 17, 2002.

9 space station: *See* “China to Construct Space Station,” People’s Daily Online, April 3, 2002; “China Plans Space Station after Unmanned Launch,” scmp.com, April 3, 2002; “Jiang, Space Station in China’s Future,” chinaonline.com, March 28, 2002.

10 suffered a budget deficit of US$29.9 billion: “Full Text of Finance Minister’s Budget Report (I),” People’s Daily Online, March 17, 2002.

11 “bloated”: James Kynge, “China Expects ‘Bloated’ 2002 Budget Deficit,” ft.com, December 18, 2001.

12 projected deficit for 2002: “Full Text of Finance Minister’s Budget Report (II),” People’s Daily Online, March 17, 2002.

13 “healthy and sustainable growth”: Agence France-Presse and Winston Yau, “China Faces Record Budget Deficit,” scmp.com, March 4, 2002.

14 China’s spending spree must end soon: *See*, *e.g.*, “China Should Concern Deflation,” People’s Daily Online, May 22, 2000 (conclusion of the Economic and Social Survey of Asia and the Pacific 2000 launched by the United Nations Economic and Social Commission for Asia and the Pacific); Andy Xie, “China’s Debt-driven Growth Runs Out,” *Asian Wall Street Journal*, November 2, 1999, p. 10. For an analysis of Beijing’s ability to spend, see Bruce Gilley, “Moment of Truth,” *Far Eastern Economic Review*, June 15, 2000, p. 58 (comments of Nicholas Lardy).

15 something even bureaucrats have implicitly acknowledged: *See*, *e.g.*, Mark O’Neill, “Deflation End in Sight,” *South China Morning Post*, January 5, 2000, Business Post, p. 4 (comments of Zeng Peiyan, Minister of the State Development Planning Commission).

16 they even talked about ending the program this year: *See* “Chinese Minister Sees Stimulus Spending Winding Down,” Reuters News Service, December 19, 2000.

[17] "proactive fiscal policy and a prudent monetary policy": Official and foreign sources differ on what Premier Zhu actually said. Dow Jones Newswires and the *South China Morning Post* report that he used the word "would." *See* Owen Brown, "Chinese Premier Zhu Defends Deficit Spending, Criticizes U.S.," Dow Jones Newswires, March 16, 2002; Jasper Becker, "I Averted Disaster, Says Premier," scmp.com, March 16, 2002. *People's Daily* in Chinese says he said "might," as reported in the transcript contained in *People's Daily*, March 16, 2001, p. 1 and 5, while the same publication in English noted that he used the stronger "would." *See* "Major Points of Premier Zhu's Press Conference," People's Daily Online, March 16, 2002.

[18] "Zhu cannot retire next year": Mark O'Neill, "Delegate Warns of Budget Deficit Dangers," scmp.com, March 6, 2002.

[19] a question that had obviously been arranged: Andy Rothman, "Zhu Has the Last Word," March 17, 2002 (research report of Credit Lyonnais Securities Asia).

[20] last had a budget surplus in 1985: *Statistical Yearbook 2001*, p. 245.

[21] "Every single penny": Stephen Roach, "Straight Talk from Zhu," *Global Economic Forum*, March 27, 2002 (available at www.morganstanley.com).

[22] Lu Wanli: Mark O'Neill, "Guizhou Official 'Flees with Road Funds,' " scmp.com, April 29, 2002.

[23] two such salary increases in 2001: Owen Brown, "Tax Bonanza Gives China Budget Options," Dow Jones Newswires, March 4, 2002.

[24] "superior assets": Willy Wo-Lap Lam, "Has China's 'Mr. Clean' Delivered?," cnn.com, March 16, 2002.

[25] more authoritative numbers: *See* "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

[26] US$169.1 billion: The Ministry of Finance has yet to issue bonds as promised to finance this partial recapitalization.

[27] US$188.5 billion: *See* "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

[28] "the deficit is still far from the internationally accepted limit": "State Bonds an Economic Lifeboat," chinadaily.com.cn, March 14, 2002. The quotation in the text is *China Daily*'s summary of Dai Xianglong's words.

[29] "hidden financial risks": "Full Text of Finance Minister's Budget Report (I),"

People's Daily Online, March 17, 2002.

30 Merrill Lynch: Merrill Lynch, "China--The New Power," January 12, 2001.

31 Fred Hu: Mark Clifford, "China's Deficit Is the Least of Its Financial Worries," Business Week Online, May 6, 2002.

32 have not been paid in months and some for longer than that: Han Dongfang, interview with author, August 29, 2001, Hong Kong.

33 Beijing transferred: "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

34 Finance Minister Xiang is allocating US$14.3 billion: "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

35 Beijing spent much more than it had originally budgeted: Charles Hutzler, "China Budgets 9.3% Spending Rise," wsj.com, March 6, 2002.

36 22.2 percent: "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

37 chaotic and disorganized: Wang Shaoguang and Hu Angang, *The Chinese Economy in Crisis: State Capacity and Tax Reform* (Armonk, New York: M.E. Sharpe, 2001), p. 12 (hereinafter cited as *Chinese Economy in Crisis*).

38 "eating in separate kitchens": *Chinese Economy in Crisis*, p. 8.

39 protection of local firms by local tax authorities: "Regional Protectionism to Be Abandoned under WTO," chinabiz.org, March 26, 2002.

40 as listed by *Forbes*: Wu Zhong, "Rich-List 46 Missing from Top Tax Names," hk-imail.com, March 30, 2002.

41 big incentive to show good results: Owen Brown, "Tax Bonanza Gives China Budget Options," Dow Jones Newswires, March 4, 2002. For a detailed explanation of the new system, see "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

42 a tax revolt that quickly spread: *See* Vivien Pik-Kwan Chan, "20,000 Farmers Riot Over Taxes," *South China Morning Post*, August 30, 2000, p. 1.

43 frequent reports of peasants committing suicide: *See, e.g.*, Fong Tak-Ho, "Hubei Tackles Woes of Farmers," scmp.com, May 6, 2002. For a general background of the plight of the peasants, see Jasper Becker, "Reaping a Harvest of Despair," *South China Morning Post*, September 24, 2000, p. 11.

---

44 the "tax for fee" experiment: Daniel Kwan, "Zhu Vows to Renew Rural Tax Reform," scmp.com, April 5, 2002.

45 expanding the experiment to still other areas: Josephine Ma, "Tax Plan Inevitable Despite Previous Problems," scmp.com, April 18, 2002; Jasper Becker, "Blueprint Aims to Boost Rural Economy," scmp.com, March 8, 2002.

46 the Anhui Province plan: *See*, *e.g*., Josephine Ma, "Rural Cash Crunch Taxes Reformers," scmp.com, January 7, 2002.

47 on hold last July: Josephine Ma, "Zhu Pledges to Protect Urban and Rural Poor," scmp.com, March 6, 2002.

48 and therefore faced bankruptcy: Owen Brown, "Tax Bonanza Gives China Budget Options," Dow Jones Newswires, March 4, 2002.

49 could have made the program a success: For background information, see "A Premier's Legacy," wsj.com, March 18, 2002.

50 "several hundred billions of yuan": Josephine Ma, "Tax Plan Inevitable Despite Previous Problems," scmp.com, April 18, 2002.

51 the oft-delayed fuel tax: "China Will Not Start Fuel Tax in Near Future," chinadaily.com.cn, May 3, 2002.

52 prospects for reform: To its credit, the central government is trying to do the same thing in the industrial sector by mandating the elimination of arbitrary charges on workers' wages. "China Urges Tax Breaks for Millions of Jobless," scmp.com, April 2, 2002. Yet the central government is not realistic. Last year it had banned cities from imposing fees on migrants and temporary residents except for a five yuan charge for a temporary resident permit. Shenzhen says that it costs 20 yuan to issue such a permit, and according to the government, it issued 3.43 million of them. Therefore, it would lose substantial revenue if it actually complied. The central government can dictate, but municipalities will not follow: Shenzhen has so far defied the ban. *See* Clara Li, "Fee Ban Too Much to Bear, Says City," scmp.com, April 2, 2002. And this raises the issue of a more important dispute over which level of government is to pay for social services for the migrants, a group that numbers at least 150 million. *See* Clara Li, "Dispute Sign of Wider Problems," scmp.com, April 2, 2002.

53 reduction of import taxes and lower tariff rates: *See* "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

54 the revenue drive cannot continue for long: Perhaps the sector worst affected by taxation is banking. For an analysis of the problems caused by taxation of the banks, see John D. Langlois, "Taxing China's Banks," *Asian Wall Street Journal*, October 12, 2000, p. 12.

[55] three times faster: Jamila Zhou, "Economists Call for Tax Reduction," scmp.com, November 29, 2001.

[56] small cut in tax rates this year: "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

[57] US$217.6 billion: *See* "Full Text of Finance Minister's Budget Report (II)," People's Daily Online, March 17, 2002.

[58] more listed companies reported losses: Bei Hu, "More Firms in Red at Close of Season," scmp.com, May 1, 2002.

[59] a staggering 28.1 percent from the year before: China's foreign exchange reserves were US$165.6 billion at the end of 2000.

[60] US$227.6 billion: "China Continues Financing in Int'l Capital Market," People's Daily Online, April 17, 2002.

[61] "have sometimes been used for unorthodox purposes": James Kynge, "Banker's Fall Throws Spotlight on China's Missing Billions," *Financial Times*, January 16, 2002, p. 10. For additional information, see Bruce Gilley, "China's Bankers: Rotten to the Top," feer.com, January 31, 2002; James Kynge, "Comment & Analysis: China's Liabilities," ft.com, January 22, 2002.

[62] "Bond fever": "State Bonds an Economic Lifeboat," chinadaily.com.cn, March 14, 2002.

[63] "investors still lack better investment alternatives": "State Bonds an Economic Lifeboat," chinadaily.com.cn, March 14, 2002.

[64] investors will be able to trade bonds: *See* "Central Bank and Ministry of Finance Promulgate T-Bond Counter Deals," People's Daily Online, April 4, 2002. For background information, see Bill Savadove, "OTC Service Expands Bank Business Scope," scmp.com, April 4, 2002; Owen Brown, "China OKs Bond Trade, Boost to Interbank Mkt," Dow Jones Newswires, April 3, 2002.

[65] only about 20 percent: Chi Lo, "Beijing's Budget Time Bomb," wsj.com, March 12, 2002.

[66] US$170.1 billion: "China's Foreign Debt Stays Stable," People's Daily Online, April 23, 2002.

[67] US$188.5 billion: "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

[68] US$61.7 billion: Ben Pedley, "China Fin Min Seeks to Curb Expansionary Fiscal Policy," Dow Jones Newswires, April 22, 2002.

[69] debt: Debt statistics require manual tabulation and are derived by tracking the amount of debt the central government issues in domestic and international markets and debt retirements. The figure in the text for 2001 is a rough estimate and is much higher than the official number released by Finance Minister Xiang Huaicheng in his most recent work report. *See* "Full Text of Finance Minister's Budget Report (I)," People's Daily Online, March 17, 2002.

[70] In every year: *See Statistical Yearbook 2001*, p. 249.

[71] Brookings scholar Nicholas Lardy: Nicholas R. Lardy, "When Will China's Financial System Meet China's Needs?," February 2000 (originally prepared for Conference on Policy Reform in China, Stanford University, November 18-20, 1999). For additional information, see Joe Studwell, *The China Dream* (London: Profile Books, 2002), p. 203.

[72] Economic strategist Chi Lo: Chi Lo, "Beijing's Budget Time Bomb," wsj.com, March 12, 2002.

[73] has not indicated: Owen Brown, "Chinese Premier Zhu Defends Deficit Spending, Criticizes U.S.," Dow Jones Newswires, March 16, 2002.

[74] "The proactive fiscal policy will definitely be phased out eventually": "China's Export Growth Rate Boosted by Resurgent Exports," Reuters News Service, April 16, 2002.

[75] "But this will be a gradual process and could take several years": "China's Export Growth Rate Boosted by Resurgent Exports," Reuters News Service, April 16, 2002.

[76] "I cannot give you a timetable": Mark O'Neill, "Beijing Heavy Spending Alert," scmp.com, April 17, 2002.

[77] "It is opportune to go": "China's Export Growth Rate Boosted by Resurgent Exports," Reuters News Service, April 16, 2002.

[78] from the same quarter last year: Peter Wonacott, "China's Economy Expands 7.6%, But Concerns Remain," wsj.com, April 17, 2002.

[79] "reckless": Ben Pedley, "China Fin Min Seeks to Curb Expansionary Fiscal Policy," Dow Jones Newswires, April 22, 2002.

[80] "and not have some problems emerge": Peter Wonacott, "China's Economy Expands 7.6%, But Concerns Remain," wsj.com, April 17, 2002.

[81] "The fiscal situation is grim": Mark O'Neill, "Beijing Heavy Spending Alert," scmp.com, April 17, 2002.

[82] "a potential time bomb": Chi Lo, "Beijing's Budget Time Bomb," wsj.com, March 12, 2002. For another comparison of China to Argentina, see Michael Pettis, "Too Dangerous to Ignore," scmp.com, March 14, 2002.

[83] stuffed their banks with their bonds: Mary Anastasia O'Grady, "Argentina's Politicians Cling to the Ways of Peron," wsj.com, April 26, 2002.